Statement of
John L. Bley
Director of Financial Institutions
State of Washington
Before the
Federal Reserve Hearing on Home-equity Lending
San Francisco, California
September 7, 2000

Good morning. My name is John L. Bley and I serve as Director of Financial Institutions for the State of Washington. With me today are Mark Thomson, the Department's Director of Consumer Services, and Chuck Cross, a senior field examiner. I have prepared written comments that have been submitted for the record, but I do wish to make some brief oral remarks.

The Department of Financial Institutions is responsible for, among other things, the licensing and regulatory oversight of non-bank mortgage companies operating in the State of Washington, as well as state-chartered depository institutions. Non-bank mortgage companies, (primarily mortgage brokers and mortgage bankers) originate well over half of all the mortgage loans in this country. For the most part, federal agencies are not the primary regulators of these companies. The majority of the regulatory oversight of these companies lies with state agencies such as our Department and compliance with both state and federal regulation is assured at the state level.

The Department examines these non-banking mortgage companies for compliance and when necessary, investigates these companies for violations of law and consumer abuse. As a result of the Department's examinations, Washington consumers received approximately $1.2 million in refunds from consumer loan lenders in the last 18 months. The Department processes approximately 300 consumer complaints a year, directing lenders and brokers to make refunds or take other action to compensate consumers when violations are found. Since 1994, the Department has conducted over 100 enforcement actions to correct abusive practices and protect Washington consumers. These enforcement actions have resulted in license revocations, individual bans from the industry, restitution to consumers, and fines.

Our staff are trained in both federal and state compliance regulation and are active in the American Association of Residential Mortgage Regulators (AARMR), the National Association of Consumer Credit Administrators (NACCA), and the National White Collar Crime Center (NWCCC). These organizations focus much of their effort on detecting, preventing and punishing mortgage fraud and fraud in general.

In the last year we have watched the issue of "predatory lending" become a major policy issue at the federal level. In much of the discussion, it has been obvious that parties to the debate are operating under different definitions of the term. In the state of Washington we have been dealing with "predatory lending" problems long before it became an issue with national attention.

In our view, based upon our years of experience in regulating mortgage lending by non-banks, predatory lending is the use of deceptive or fraudulent sales practices in the origination of a loan secured by real estate. Federal disclosures are too complex for many borrowers and the borrowers turn to loan officers to explain the terms of their loan. Thus, predatory lending is an abuse of misplaced trust. Predatory lending becomes possible when a borrower trusts a loan officer to explain the terms of a loan and the loan officer commits deception by abusing this trust. The deception may include hiding high fees or points, a variable rate loan instead of a fixed rate loan, unneeded insurance or a prepayment penalty, or it may take the form of selling a consumer a subprime mortgage loan when they could qualify for a lower cost conventional mortgage loan.

I have attached as Exhibit A a memorandum authored by the Department's chief mortgage investigator, Mr. Chuck Cross, which describes the deceptive practices we have observed in Washington. Mr. Cross has spent the last five years on the front lines fighting predatory lending practices and we believe that his memorandum provides a comprehensive discussion of the practices that are causing the problem.

It is important to note that predatory lending is not a new problem. State regulators have been dealing with this very same issue under a different name for years. What was once called mortgage fraud is now called predatory lending. Under either name, our mission to investigate violations and enforce the law has remained the same.

I know you have asked us to address a series of questions regarding the Federal Reserve System's authority to make certain amendments to the regulations enforcing the Home Ownership and Equity Protection Act (HOEPA) amendments to the Truth in Lending Act (TILA). I am afraid that our experience in Washington is that the HOEPA amendments have had very little impact upon predatory practices in mortgage lending, and that any amendments the Board of Governors might make to those regulations are also unlikely to have a significant impact upon the problem.

Over the last three years, the Department has brought administrative cases against Nationscapital Mortgage Corporation and First Alliance Mortgage Company. In both of those cases, many consumers told us that they received high rate, high fee, variable interest rate loans when they thought they were getting fixed rate loans and did not know about the high fees. In most if not all of these cases, it appears that consumers "received" their Truth in Lending Act disclosures to no substantive effect.

Our view in Washington is that the problem of predatory lending should be dealt with surgically. Public policy should promote the availability of credit to all of our communities, as long as that credit is provided in a prudent, honest, fair, and non-discriminatory manner.

From our "front-line" battle with predatory lenders, our Department believes that a three-pronged approach to address predatory lending would be the best possible cure. The three-prongs of this approach are simplification of the disclosures, establishment of prohibited practices, and aggressive enforcement.

Simplification of Disclosures:

The Federal Reserve Board shares some of the responsibility for creating an environment in which the only thing most borrowers can do is to trust the loan officer to tell them their rates and terms. Current mandatory disclosures are so voluminous and so confusing that borrowers don't understand them. Instead, the borrowers rely on what the loan officer says. Loan officers have confessed to the Department that the complexity of the disclosures creates confusion which is the absolute opposite result of the policy goals of such rules.

Furthermore, complex federal regulations lay traps and create uncertainty in disclosure by mortgage companies. We know from first hand experience that the vast majority of mortgage companies are confused about the calculations contained in the two primary disclosures: the Good Faith Estimate and the Truth in Lending disclosure. While banks may have sophisticated internal controls for compliance with the regulations, the majority of companies producing mortgages in this country clearly do not.

Finally, the regulators themselves are frequently in disagreement over the application and coverage of federal regulations. This has created a vicious cycle of interpretation and uncertainty, which over time has created an ad hoc layer upon layer of staff commentary and interpretive opinion that has served to create an industry unto itself rather than a clarification of the regulations. Almost two years ago, the Federal Reserve and the Department of Housing and Urban Development jointly issued a report about the possible harmonization of their disclosure requirements. Their report concluded that statutory changes were necessary for this simplification. We have not seen the Federal Reserve vigorously support the necessary legislative changes. We respectfully suggest that the Federal Reserve should again report to Congress that the applicable laws should be amended to allow simpler, clearer loan disclosures.

This Department urges simple disclosures, simply provided and simply explained. We have attached as Exhibit B two draft simplified disclosure forms to these comments. They undoubtedly can be improved upon, but could serve as a starting point for discussions to improve both the readability and relevance of disclosures to the borrower.

Prohibited Practices:

We have attached as Exhibit C a copy of the Department's response to the Office of Thrift Supervision's (OTS) Announcement of Proposed Rulemaking (ANPR). In our comments, the Department contends that the only true solution to predatory lending is to enact a statutory provision prohibiting the use of unfair and deceptive sales practices in the origination of mortgage loans.

The Washington Mortgage Broker Practices Act contains a list of such prohibited practices. This list could surely be augmented. The key is that the list address unfair and deceptive acts and practices in the sale and origination of the mortgage. These provisions can also incorporate by reference a state's consumer protection law, perhaps creating a private cause of action.

Enforcement:

We remain perplexed at the existence of federal criminal penalties for any consumer defrauding a lending institution, while the penalties against lenders for defrauding consumers are for the most part administrative and financial in nature. A general worst-case scenario for a lender deceiving a consumer is a disgorging of the profits associated with the violation and an admonishment not to do it again. We know that some lenders see no downside to the undertaking of mortgage fraud. At worst, the penalty is to stop enriching themselves.

This Department believes that the harm realized directly by consumers from predatory lending is far greater than the harm realized by financial institutions as victims. How can we compare the emotional devastation, impairment of access to credit and loss of home to a bottom-line corporate write-off? The penalty to those who engage in predatory conduct should be at least as great, if not greater, than the penalty to the consumer.

This Department encourages harsh penalties for acts of predatory lending. Such penalties should include: restitution, monetary fines, permanent injunctions from lending, and criminal conviction for individuals. In cases egregious enough to convince a prosecutor to accept them, violators should be constitutionally deprived of their personal liberty.

Cases based upon fraudulent and deceptive sales practices are not easy to make. It takes more than the standard financial examination techniques. Regulators must conduct investigations, interview consumers, document sales techniques, scripts and training, and prepare a case that demonstrates a pattern and practice of using deceptive and fraudulent sales practices. Its takes time, money, effort, and is often an unpleasant and confrontational process. But we believe it is the only way to truly address the problem of predatory lending.

Thank you for the opportunity to share our thoughts.

State of Washington
DEPARTMENT OF FINANCIAL INSTITUTIONS
Division of Consumer Services
Memo From The Investigation/Enforcement Section

Date: April 27, 2000

To: Director John Bley, Assistant Director Mark Thomson, Special Policy and Enforcement Administrator Scott Jarvis

From: Chuck Cross, Supervisor Investigation/Enforcement

Subject: Predatory Lending Practices

This memo is an overview of various types of predatory lending practices that have been identified by the Department of Financial Institutions (DFI). These practices may be conducted by mortgage brokers, mortgage lenders, banks, or others with access to financing arrangements. In this memo these groups are combined into a single term, "mortgage company."

DFI has found that the majority of deceptive practices take place in refinance transactions for "subprime" or "hard money" loans. The apparent reason for this is that a refinance transaction involves fewer parties than a purchase transaction. The more parties involved, the more difficult the artifice is to sell or cover up.

Some mortgage companies have become very proficient with deceptive sales pitches in recent years. The perpetrators of this type of consumer fraud have designed sales scripts for their loan officers that overtly quote the regulations and requirements while subverting the meaning of those regulations and requirements. When removed from the context of the sales meeting the scripts can appear to be innocuous forms of solicitation.

Regulatory efforts to uncover these practices have been confounded by "clean files" in which the mortgage company has taken great care to dot all "i's" and cross all "t's" for appearance sake. For example: full disclosures that were never delivered to the borrower are available in the loan files for examiner review. It is not until the regulatory investigator has cause to interview individual borrowers that the failure to disclose is discovered. Additionally, borrowers are sometimes required to sign documents stating that they have been fully apprised of all elements of their loans including federally required disclosures, whether full disclosure has occurred or not.

Following is a list and discussion of the primary types of deception, fraud and predatory practices identified by DFI in the last couple of years. This list is not all-inclusive, but rather addresses the chief problems we have noted in parts of the industry. If requested I would be happy to provide a follow-up list of recommendations to address and help correct each of these types of deception.

Loan Type

DFI has identified large numbers of borrowers who have apparently been deceived about the type of loan they have transacted for. Loan type deception is generally related to the sale or delivery of an adjustable rate mortgage (ARM) in place of a desired fixed rate mortgage. The borrower is not alerted to the ARM by the rate associated with the ARM, because it will often be at a start rate approximating that which is currently being offered on fixed rate mortgages.

This deception is all the more egregious because the conventional ARM will generally carry a rate starting much lower than the fixed rate. The result is that not only is the borrower deceived into the ARM, but a high rate ARM as well. These loans may be tied to volatile indices, have short adjustment periods, and high annual and lifetime caps. To further compound the injury to the borrower, these high rate ARMs usually carry a large prepayment penalty (discussed later), making it cost prohibitive for the borrower to refinance the loan once they identify the deception.

The following methods of deception have been identified:

1. The borrower is solicited for a fixed rate mortgage with the promise or understanding of a conventional market rate. The borrower unknowingly signs for an ARM. The borrower becomes aware of the ARM at the first payment adjustment date (6 months or 1 year). There are a variety of ways in which the "signer" is able to obtain closing signatures from the borrower. Some or all of the following may be employed:

   a. The mortgage company's own staff or affiliated escrow company handle the signing of closing papers. It is impractical for this degree of deception to take place when the signing is conducted by an independent third party closer. However, DFI has seen situations in which non-affiliated closing companies do assist the mortgage company in the fraud.
   b. The signer employs techniques to hide the pertinent information that would alert the borrower to the ARM loan such as, placing Post-It Notes over information, holding a hand over parts of disclosures while pointing towards other parts of the disclosures, and changing the order of multiple page documents so that the signature page comes first. A version of this last method is to tag the signature pages only and then rush the borrower from signature page to signature page, ignoring the disclosures and loan information in between.
   c. Fail to deliver the required disclosures and subsequently forge the borrower's signature. Forged signatures may be accompanied by a false notarization.

2. The borrower is solicited for a fixed rate mortgage. The borrower commits themselves emotionally and financially to the transaction only to learn at closing that they have been switched into an ARM. The borrowers are convinced by controlling sales scripts that some element of their credit history, employment or property value disallows them to obtain the fixed rate loan they had been promised. The sales scripts combine delivery of negative information along with a reinforcement of the benefits the borrower will derive from the new loan, with some of the benefits being direct lies or cover ups of the disadvantages associated with the loan. Throughout, the sales person focuses the borrower on "hot buttons": wants, issues, or problems that drove the borrower to consider refinancing in the first place.

It should be noted that the sales people are not above using fear and threats of financial damage to get the borrower to sign the closing papers. Many borrowers have relayed their discomfort and bewilderment during the closing process on these loan transactions.

3. Convincing the borrower that the ARM will automatically convert to a fixed rate mortgage after one year is a recurring sales theme identified by DFI. This sales pitch is generally used in conjunction with the deception in 2 above. It is employed on borrowers who refuse to accept the ARM despite the misrepresentations and pressure. Here the borrowers are promised that the loan will become a fixed rate loan after they have shown that they are able to make a year's worth of payments as agreed.

In other instances, a company provides the borrowers with a letter purporting to guarantee the conversion of the loan. However, a close reading of the letter shows that the company has promised nothing more to the borrower than to consider a full cost refinance after one year. In such situations the borrower is faced with large prepayment penalties and new costs to refinance.

4. An ARM loan is sold with the understanding that it holds similar amortization and interest rate savings as the fixed rate mortgage. In some instances, a company may use a deceptive disclosure that uses information derived from the Truth in Lending Disclosure to convince borrowers that ARMs amortize like fixed rate mortgages.[1] This disclosure and accompanying sales pitch convinces borrowers that the ARM holds the same benefits for them that the fixed rate mortgage holds. The borrowers are shown not only a reduced term to maturity (e.g. 30 years reduced to 15 years), but also a substantial interest savings.[2]

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[1] ARM loans do not amortize like fixed rate loans. The contractual principal reduction on fixed rate loans is known and fixed. Additions to principal above the monthly payment reduce the term to maturity. The amortization rate of principal on ARM loans varies annually based on changing rates. While additions to principal reduce the outstanding balance, the new balance is annually recast over the remaining term, thereby having an impact on payment. In other words, the term to maturity is not necessarily affected by additional payments to principal and due to changing rates the affect on payment remains unknown.

[2] DFI has recalculated the information given in many of these disclosures using "real" data and has found that the interest savings disclosed to the borrower is generally inaccurate by more than $100,000.

Loan Amount

The loan amount deception is generally accompanied by the loan cost deception and the monthly payment amount deception (discussed later). It has been alarming for regulators to find that the largest aid to the deceiver in this sales artifice is the federally required Truth in Lending Disclosure. The scam will often work like this:

The borrower has determined that they want a loan of a specific amount, say $80,000. The mortgage company proceeds to show the borrower an "Amount Financed" of $80,000 from the Truth in Lending Disclosure, while transacting a loan for $100,000 with the borrower.[3] Federal disclosure regulation requires the mortgage company to show the Amount Financed to the borrower, but does not require the borrower to be shown the actual loan amount.

DFI has reviewed sales scripts that employ dialogue such as:

> Borrower: "What is my loan amount?"
>
> Sales Rep: "Your amount financed is $80,000."
>
> Borrower: "So my loan amount will be $80,000?"
>
> Sales Rep: "Make no mistake about it . . . your amount financed is $80,000 as you can see from this federal disclosure form."

The sales rep has not made a false statement, yet has led the borrower to believe that their loan amount is far less than they have signed for. The deception is held in what the sales rep did not say to the borrower. However, an unsophisticated borrower does not know that Amount Financed is a calculated disclosure unique to the Truth in Lending Disclosure and bears little resemblance to the loan amount they have obligated themselves to, and that the difference between the two is profit to the mortgage company. The borrower first finds out that they have a much larger loan than believed when they attempt to refinance or sell their residence.

The mortgage company's professed defense is that they have followed the federal disclosure requirements to the "T" and the borrowers did not choose to rescind the transaction within the rescission period.

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[3] The Amount Financed is derived by taking the loan amount and subtracting the Prepaid Finance Charge. The Prepaid Finance Charge will be comprised primarily of the mortgage company's loan origination and "junk" fees. Therefore, a $100,000 loan carrying fees of $20,000 will reflect an Amount Financed of $80,000.

Loan Costs

Borrowers have consistently reported that they were unaware of the costs paid on their loan. They have usually been sold on a no-cost or low-cost loan only to find that they have been switched to a high cost loan. It is not uncommon to find a borrower paying $10,000 to $15,000 in fees when they believed they would be paying little or no fee. There are many methods by which a mortgage company can hide its fees from the borrower. A couple are:

1. Failing to make disclosures of the fees. Federal regulations only require that Good Faith Estimates (GFEs) and Truth in Lending Disclosures (TILs) be placed in the mail within three days of the date of application (for refinance transactions the TIL doesn't even have to be given until just before consummation). No affirmative effort or verification of receipt is required on the part of the mortgage company. DFI has investigated complaints in which the consumer claims to have never received the disclosures, however, the company shows the disclosures in its files and claims to have placed them in the mail. This failure to make disclosures is believed to occur even at consummation of the transaction where the borrower never sees the disclosure, or sees a different disclosure, and their signature is subsequently forged on the real disclosure.

2. Borrowers are shown the disclosures, but are led to believe that the costs appearing on the GFE are either just examples, or will be covered for the borrower in the form of rebate to the mortgage company by the up-line lender. In some cases, a company will prepare the Itemization of Amount Financed disclosure to show the borrowers not paying the origination fee of several thousand dollars, when in reality the borrowers did pay these fees.

Payment Amount

An increasing concern among borrowers is the true amount of their monthly payment. It appears that borrowers are deceived about what is included in the monthly payment to make the loan more palatable. An example of this deception follows:

A borrower holds a current mortgage with a monthly payment of $1,000 including principal, interest, taxes and hazard insurance (PITI). The borrower is solicited for a new loan and is promised that their new payment will be only $900 per month. The borrower is informed that the new payment will include PITI and agrees to the transaction. The borrower does not find out until six months or a year later when taxes and insurance are due that their payment included only principal and interest (PI).

Once the taxes and insurance are factored in the borrower finds that their payment is actually higher than their old payment. This is often the point at which borrowers discover that they have an ARM, the loan amount is higher than they thought, they paid more than agreed in costs and a prepayment penalty prevents them from refinancing the loan.

Prepayment Penalty

For most loans, there is no prohibition against prepayment penalties. From the mortgage company's perspective there is an expectation of earnings on the loan for at least a reasonable period of time. A prepayment penalty is charged to offset the loss of this earnings expectation when a loan is refinanced in the early years following consummation.

Federal regulations require very little in disclosing prepayment penalties. The mortgage company's obligation is to include a fine print, vague reference to the existence of a prepayment penalty on the face of the TIL. This part of the disclosure is buried within a large amount of other information making the prepayment penalty disclosure less than conspicuous. Further, the prepayment penalty clause is carried deep within the note, is confusing to read and may be referenced as a "prepayment opportunity."

A standard prepayment penalty will require the borrower to pay six months worth of interest on any principal payment exceeding 20% of the original balance of the loan within the first five years. Obviously in a refinance transaction a borrower would be faced with a penalty of six months interest based upon 80% of the payoff on the loan . . . a sizable figure at any point during the first five years.

Generally, the deceptive mortgage company is able to avoid the question of prepayment penalty altogether. The borrower simply does not notice the fine print and does not query the sales representative on this matter. When the borrower does question the prepayment penalty they may be met with one of the following answers:

1. "There is no prepayment penalty." A direct lie, but effective if the borrower does not notice the buried disclosure.
2. "The lender will waive the prepayment penalty when you refinance." Again, a direct lie. The lender or investor in the loan has no incentive to waive the prepayment penalty as they invested in the loan based upon that protective feature.
3. The borrower is informed that all loans have a prepayment penalty and there is nothing that can be done about it. This is a false statement. Most loans do not have prepayment penalties and the prepayment penalty can be waived up-front in virtually all transactions.
4. "It is a prepayment opportunity." Here the borrower is informed that they have the opportunity to make up to 20% in principal reductions per year without a penalty. They are not informed that should they choose to refinance the loan (a goal of most borrowers agreeing to accept these types of "hard money" transactions) they will be faced with a large penalty.

DFI has found that there is incentive for loan officers to hide the existence of the prepayment penalty from the borrower. When a loan is sold in the secondary market, a loan with a prepayment penalty carries a premium relative to a loan without a prepayment penalty. When a loan officer cannot sell a borrower on a prepayment penalty, this loss of the premium on the sale of the loan is often passed down to the loan officer in the form of a reduced commission on the loan.

There are hidden damages in the prepayment penalty deception. Borrowers not understanding they have a prepayment penalty may realize financial loss by taking a refinance transaction nearly to conclusion only to find out at closing they cannot afford the refinance or all of the gain from the refinance is eaten up by the prepayment penalty. There are additional victims, however. Buyers of a property may find that the seller is unable to complete the sale due to a prepayment penalty and the seller of a new property to holder of the loan with the prepayment penalty may lose their sale as well. Additionally, third party providers such as Realtors, the new mortgage company, the escrow company and others are losing business to this type of deception.

Equity Skimming

All of the above categories of deception may constitute equity skimming in that the borrower's equity is skimmed away in the form of unknown costs or negatives associated with the transaction. However, direct equity skimming by mortgage companies is also alive and well. It is common for a borrower to simply lose their property to an unscrupulous mortgage professional. The fraud typically works like this:

The consumer is convinced that it is in their best interest to allow a claim to their property by the mortgage professional. This may be done for a variety of reasons:

1. The consumer has poor credit or work history or is unable to find financing due to factors such as age. The consumer quit claims the property to the mortgage professional who claims they will obtain a loan in their name for the consumer and then return the property after the loan has been arranged. A loan may be arranged by the professional to take out the underlying lender, however, the property is not returned to the consumer and is essentially stolen.
2. The consumer allows a recording of a lien against a portion of the property in exchange for fees owed in a loan transaction. While this may be a legitimate part of a transaction, the mortgage professional may intend to take over the borrower's property.
3. The consumer is convinced that the mortgage professional can sell the property for them and deliver the equity back minus a reasonable fee. In this case the borrower quit claims the property to the professional who subsequently sells the property and retains all the proceeds.
4. The mortgage professional assists the consumer with a refinance transaction, but claims a false debt that must be paid through escrow from the loan proceeds. The mortgage professional creates a fictitious, but legitimate sounding, credit source that draws no alarm by the escrow company. The mortgage professional is the recipient of payment on the false debt.

Exhibit B

Simplification of Disclosures and Consumer Education

Increased consumer awareness is essential to eliminate predatory lending. Our investigators' experience, in hundreds of cases, is that people would not have fallen prey to a predator if they had only known the rates and terms of their loans. Helping people understand the rates and terms of a loan before they agree to receive the loan is the best way to prevent predatory lending.

Improving understanding requires us honestly to acknowledge the challenges that we face. Earlier this year one federal agency reported that survey results indicate 18 percent of adult Americans do not know what "principal" and "interest" are. We believe that low-income borrowers probably make up a disproportionate share of that 18 percent. How can we improve their understanding of loan rates and terms?

Some people say the remedy is better education. We agree that education is important. We are familiar with the problems of education, however. A majority of adult consumers are not likely to take the time for some form of classroom education. The most important kind of education to prevent predatory lending is the education that occurs in the course of the loan origination process.

The remedy to many predatory lending problems is to effectively require that loan originators properly disclose the loan terms. These disclosures must be given early in the loan origination process to put them on their guard against predators.

Many people say disclosures should be simplified. As examples to demonstrate that simple, clear disclosures are possible, we have included in this exhibit two draft disclosure forms. We believe that all the crucial facts can be boiled down to one page as you see in each of these two alternatives. The words in these alternative forms are plain, as they must be to stop predatory lending. Loan applicants need very strong and plain disclosures.

Here's how we think this form can be most useful. We believe that regulators and consumer education specialists can work together to develop a 20-minute video to explain this form. Originators of subprime loans would be required to reproduce and send this video to loan applicants with the form, a reasonable period prior to the loan closing. The presence of the videocassette would make this a thick mailing, easy for the loan applicant to see in a pile of junk mail.

The video would, if possible, use spokespersons that subprime loan applicants respect. For example, subprime lenders have demonstrated that their customers respect sports stars, so we would try to find a nationally famous sports star who would be willing to volunteer his or her services without pay to produce this video.

The video would explain what the terms on the disclosure form mean, and how to watch for bait and switch scams by looking for differences between the form as mailed and the later version of the form as presented at closing. We have tried to simplify the form as much as possible so that it can realistically be explained in a 20-minute video.

Nationwide use of a short, standardized disclosure, as mandated by federal law, thus would greatly ease the process of consumer education.

READ THIS FORM CAREFULLY IN ITS ENTIRETY

PROPOSED TERMS AND COSTS OF YOUR MORTGAGE LOAN

This disclosure is provided in addition to specific disclosures that may be required under federal and state law. The intent of this disclosure is to provide you with a simple, clear explanation of your proposed loan terms and costs. Additionally, by following the steps outlined at the bottom of this document, you may compare the proposed terms to the final terms at closing.

LOAN AMOUNT	LOAN TYPE	RATE	PAYMENT
$100,000.00 .	30 YR ADJUSTABLE	7% SEE NOTICE 1 BELOW	$925.30 SEE NOTICE 2 BELOW

THE FOLLOWING COSTS ARE PROPOSED ON THIS LOAN

TOTAL FEES TO LOAN ORIGINATION COMPANY	$ 2,500.00	
TOTAL FEES TO LENDER FUNDING LOAN	$ 1,300.00	
TOTAL FEES TO ALL OTHER SERVICE PROVIDERS	$ 1,800.00	
TOTAL FEES YOU WILL INCUR		**$ 5,600.00**

THE FOLLOWING TERMS APPLY TO YOUR LOAN

1. YOUR RATE IS LOCKED ☐ NOT LOCKED ☒. IF YOUR RATE IS LOCKED, YOU HAVE A RIGHT TO KNOW THE TERMS OF THAT LOCK. YOUR RATE MAY ADJUST UPWARDS BY 1.0 % EVERY 12 MONTHS UNTIL IT REACHES 13.0 %
THIS RATE ADJUSTMENT MAY OCCUR REGARDLESS OF ANY OTHER FACTORS.

2. THE PAYMENT INCLUDES $ 260.00 OF ☒ TAXES ☒ INSURANCE ☐ MTG INS. ☐ OTHER.
YOUR CONTRACTUAL (NOTE) PAYMENT EQUALS $ 665.30 .

3. $ 0 OF THE ABOVE COSTS ARE INCLUDED IN YOUR LOAN AMOUNT.
$ All OF THE ABOVE COSTS WILL BE PAID BY YOU AT CLOSING.

4. YOUR LOAN DOES ☒ DOES NOT ☐ CONTAIN A PREPAYMENT PENALTY. THE TERMS OF THIS PENALTY ARE WRITTEN IN YOUR NOTE. THIS PENALTY MAY BE SIGNIFICANT AND MUST BE PAID BY YOU IN THE EVENT YOU REFINANCE THE LOAN OR MAKE SIGNIFICANT ADDITIONAL PAYMENTS TO PRINCIPAL.

PROPOSED TERMS VERSUS FINAL TERMS

The terms provided to you in this disclosure are estimates. However, if any of these estimates increase, for any reason prior to the signing of closing papers, the below named company will provide you with revised proposed terms that match your closing terms at least three days before the date of signing closing papers.

HOW TO COMPARE

The Loan Amount, Loan Type, Rate, Rate Adjustment, and Note Payment should be compared to the Note you sign at closing. The costs identified above are derived from a disclosure form known as a Good Faith Estimate. You should compare the costs on this form to the Good Faith Estimate before signing either disclosure. You should compare the costs on this disclosure, or a revised version of this disclosure, to the HUD Settlement Statement you will receive at closing.

This disclosure was delivered by _______________________________________ (Representative) of

_______________________________(Company), on _____________________(Date).

___________________________________. ____________________________________.

Borrower Date Borrower Date

FOR YOUR OWN PROTECTION DO NOT DATE THIS FORM ANY OTHER DATE THAN THE DATE ACTUALLY RECEIVED BY YOU. DO NOT LEAVE THE DATE SECTION BLANK.

COUNT THE COST! You can lose your home if you do not pay this loan back! Right now you have a right to turn down this loan and to tell any salesman that you don't want to buy the property, merchandise or service that he or she wants to sell to you.

PROPOSED TERMS AND COSTS OF YOUR MORTGAGE LOAN

RATE	LOAN TYPE	PAYMENT	LOAN AMOUNT	FEES
____%	__ YR **ADJUSTABLE**	$________.__	$_________.	**$** ______

[If rate is locked:] This rate is guaranteed ("locked") for you until [__date___] only. After that it will **not** be locked.

[If rate is teaser] Unless the cost of money falls, your rate will go up to __.__ percent after __ months.

The monthly cost of money you owe at this [post-teaser] rate will be **$______.__ per month**.
If you do not pay at least this monthly cost, the amount that you owe will grow!
If you do not pay more than this monthly cost, the amount that you owe will not shrink!

At this rate, you must pay at least $______monthly in order evenly to shrink the amount you owe.
[If prepayment penalty would apply to fully amortizing payment:] **You should look for another loan, because a prepayment penalty (see below) will apply to such a monthly payment under this loan.**

The rate can go up! To show you the possible effect of rising rates, here's how the rate will go up and, if you pay only the monthly cost that will keep the amount that you owe from growing or make a larger minimum payment required by the lender, how the monthly dollar cost of money will increase.

[If rate is indexed] If the cost of money rises, the rate can go as high as __.__ percent (a cost of **$______.__ per month**) during the next three years, and can go as high as __.__ percent (a cost of **$______.__ per month**) during the next six years, depending on the cost of money at that time in the future.

Total amount that you owe before this loan is made (according to what you have told us): $___,___.__.

Amount (not including fees or penalties for prepayment*) that you owe under this loan: $___,___.__.

Total amount that you will owe (old debt plus new debt) immediately after this loan is made: $___,___.__.

*If you pay this loan off early, this loan will require you to pay these additional prepayment "fees" (penalties):
$__,____ if you pay more than $______ in the first year after you get this loan
$__,____ if you pay more than $______ in the second year after you get this loan
$__,____ if you pay more than $______ in the third year after you get this loan
$__,____ if you pay more than $______ in the fourth year after you get this loan
The penalty for prepayment would be in addition to the total amount that you normally owe under this loan.

WHO GETS THE MONEY. You do not get all the money that you are obligated to pay under this loan. You get $_____. The seller gets $_______. The loan representative who is trying to talk you into this loan gets $______. The loan origination company gets $______. The lender funding this loan gets $_______. Other service providers get $______. The total points and fees to be paid amount to: $_____.

Keep this form! When you get your loan, you will receive another one of these forms, describing the final terms of your loan. By comparing this form to that form, you may compare the proposed terms to the final terms at closing. The terms provided to you in this disclosure are estimates. However, if any of these estimates increase, for any reason prior to the signing of closing papers, the below named company will provide you with revised proposed terms that match your closing terms at least three days before the date of signing closing papers.

This disclosure was delivered by ______________________________ (Representative) of

______________________________(Company), on ____________________(Date).

______________________________. ______________________________.
Borrower Date Borrower Date

FOR YOUR OWN PROTECTION DO NOT DATE THIS FORM ANY OTHER DATE THAN THE DATE ACTUALLY RECEIVED BY YOU. DO NOT LEAVE THE DATE SECTION BLANK.

July 3, 2000

Manager, Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street N.W.
Washington D.C. 20552

RE: Comments from the Director of Financial Institutions, State of Washington, on Responsible Alternative Mortgage Lending, Advance Notice of Proposed Rulemaking

Dear Sir or Madam:

The State of Washington Department of Financial Institutions (DFI) is pleased to have the opportunity to comment on the Office of Thrift Supervision's (OTS) advance notice of proposed rulemaking (ANPR) regarding predatory lending. DFI is responsible for regulating state-chartered banks, thrifts, and credit unions, and state licensed mortgage brokers, mortgage bankers, and consumer loan companies. All of these entities make mortgage loans and may on occasion operate under regulations promulgated by OTS under the Alternative Mortgage Transaction Parity Act (AMTPA).

Introduction:

DFI has undertaken several significant investigations of predatory lending in Washington State and we are currently conducting at least one case against a predatory lender. We have made significant contacts with other regulatory and law enforcement agencies throughout the country and have shared information, investigative tactics and strategies. We have a substantial history investigating and taking regulatory action against deceptive mortgage lending practices. This experience has lead us to the belief that predatory lending is, at the core, a problem of deceptive sales practices, and that particular loan terms, such as prepayment penalties or balloon payments, are not the problem in and of themselves, but become a problem in the context deceptive sales practices targeted at financially unsophisticated borrowers.

In offering these comments, DFI is concerned that certain sub-prime mortgage lenders have employed deceptive sales practices to target financially unsophisticated borrowers, convincing them to accept loan terms that they frequently are not aware of, that they do not understand, and that they later learn are grossly unfavorable to their financial health and welfare. Those victimized by predatory lenders are usually those least able to protect themselves, the financially unsophisticated members of our communities, the elderly, residents of low-to-moderate income neighborhoods, and those with English as a second language. These victims are devastated by the experience. Beyond their financial losses, (losses that may include their most significant financial asset, their home), the victims are often also robbed of their self-confidence, their self-respect, and their sense of financial security in their own home and neighborhood. We must take appropriate action to protect these individuals under the law.

However, DFI urges OTS and other regulatory agencies, both federal and state, to make a distinction between predatory lending practices, which are generally synonymous with deceptive sales practices and are often violations of existing consumer protection law, and loan terms, which in and of themselves are neutral tools but which become abusive when they are imposed upon an unknowing and unsophisticated borrower.

DFI further urges OTS and other regulatory agencies to carefully weigh the impact that their response to predatory lending practices may have upon access to capital for higher risk borrowers. Across the board prohibitions on selected loan terms on high cost loans may have the unintended consequence of severely limiting credit availability to these borrowers.

Definition of Predatory Lending:

Throughout the extensive discussion of predatory lending, it is rare to find a definition of the term. It is unlikely that an effective strategy can be developed to counter the practice of predatory lending until a definition of the term is agreed upon. We notice that no definition is offered in the ANPR.

DFI has adopted the following definition of the term predatory lending:

> Predatory lending is the use of deceptive or fraudulent sales practices in the origination of a loan secured by real estate.

We note that the U.S. Treasury and the U.S. Department of Housing and Urban Development have adopted a similar definition in their joint report on predatory lending. In the report, they define predatory lending as follows:

"Predatory Lending -- whether undertaken by creditors, brokers, or even home improvement contractors – involves engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower's lack of understanding about loan terms. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices."

We believe these definitions accurately focus on the use of deceptive sales practices as the heart of the problem. Our view is that legislative solutions should focus on prohibiting unfair and deceptive acts and practices in the origination of the loan, on establishing severe penalties for both companies and individual employees who use these unfair and deceptive sales practices, including criminal penalties, and authority for regulatory agencies to order restitution to borrowers damaged by such unfair and deceptive sales practices. In addition, private causes of action should be authorized.

Federal Preemption of State Law:

Limitations on interest rates and fees, and other limitations on the use of certain loan terms such as prepayment penalties or balloon payments, have existed in many state laws for many years. Many states have usury statutes that limit the interest rates and fees that a lender may legally charge a borrower. Many states also have consumer finance statutes, laws that specifically recognize that higher rates are necessary to induce lenders to loan to higher risk borrowers. These consumer finance statutes typically authorize lenders to make loans at interest rates in excess of the usury rates, but also impose restrictions on other fees and frequently impose restrictions on the use of loan terms like prepayment penalties and balloon payments. These restrictions were enacted in state law as a result of experience, and provided an effective check on overreaching by lenders.

In the early 1980's, when inflation and interest rates soared, the usury restrictions in many states' laws created price ceilings that prevented the extension of credit on profitable terms. Credit shortages were the result. Congress responded by preempting state law restrictions on rates, fees, and charges on first mortgage loans. As consumers and lenders attempted to deal with these unique economic circumstances, they pursued alternative mortgage structures, such as adjustable rate mortgages (ARM's), balloon payments, and mortgage loans with differing terms and amortization periods. Again, state law restricted the use of such loan terms and Congress responded by preempting these state law restrictions to ensure equal access across states and to ensure parity between federal and state regulated lenders.

The same soaring inflation and interest rates exposed the weakness in the predominate form of funding mortgage lending in the country at that time, the small community savings and loan association. The result was the collapse of the traditional savings and loan industry, the creation of an enormous secondary market in mortgage loans where large pools of mortgages are securitized, and the growth of a mortgage brokerage industry that now originates more that half of all mortgage loans originated. Within this new lending environment, where the loan originator is frequently not the ultimate holder of the debt, agency problems abound. While buy-back provisions and other contractual mechanisms are used to attempt to tie the economic interests of the originator to the quality of the loan originated, these contractual provisions are imperfect. The ability of the loan originator to make large sums upfront from the origination of the mortgage loan, particularly in the sub-prime market, provides an enormous incentive to employ abusive sales practices to maximize loan origination fees, and to then avoid the costs associated with these business practices by declaring bankruptcy when the secondary market or regulators finally catch up to them.

The preemptive federal laws provided states with the opportunity to opt out of the federal preemptions, but most did not avail themselves of this opportunity, since in the unique economic circumstances of the time, to do so would have reduced the availability of credit to their citizens. As a consequence, many of the state law prohibitions against excessive interest rates and loan origination fees, and the state law prohibitions against the use of loan terms that are usually cited as predatory, are now subject to preemption.

This is significant for three reasons. First, the economic conditions that gave rise to the preemptions can now be seen in retrospect to have been relatively unique and temporary in nature, but the preemption was permanent and has created conditions in a new economic environment where the consumer protection provisions of many state laws are rendered impotent. Second, a whole new set of mortgage lenders and mortgage brokers are operating in a whole new environment where the loan originator has enormous incentives to maximize originations and the upfront fees that go with them, where agency problems abound and the contractual solutions are imperfect, and where ultimate investors in the mortgage appear to be immune to liability for abusive sales practices used in origination of the mortgage loans, and therefore have little incentive to perform extensive due diligence. And third, the existence of federal preemptions and the federal agencies' aggressive implementation of these provisions have severely limited the ability of state legislatures to adopt in state law direct limitations on interest rates, fees, or the use of loan terms such as prepayment penalties or balloon payments.

The only mystery in this set of circumstances is why it took so long for a predatory lending problem to evolve to the point where it was recognized.

Our Experience in Washington:

We have attached a memorandum from Mr. Chuck Cross, DFI's chief mortgage investigator, identifying the primary forms of predatory lending that we have observed in Washington. These deceptive lending practices include:

1. Loan Type: misleading the borrower into accepting an ARM when they want, and believe they are getting, a fixed rate mortgage.

2. Loan Amount: misleading the borrower into accepting a higher loan amount by concealing the mortgage lender or mortgage brokers fee and its impact upon the amount of the loan.

3. Loan Costs: misleading the borrower about the costs of the loan, typically the fees going to the mortgage lender or mortgage broker.

4. Payment Amount: misleading the borrower about the amount of their monthly payment, usually by indicating that the principal and interest payment is their only payment, when in fact, taxes and insurance will be added on.

5. Prepayment Penalties: misleading the borrower about the existence of a prepayment penalty, which then makes refinancing out of the loan prohibitively expensive once the borrower recognized the other deceptions they have been subjected to.

6. Equity Skimming: convincing the borrower to give the loan officer an interest in their property, whereupon the loan officer uses this position of trust to steal the equity in the property. This is a much more direct and less expensive method than foreclosure.

During the late 1990's, many sub-prime mortgage lenders were licensed under Washington's Consumer Loan Act (CLA). The CLA provides an exemption from Washington's usury law, allowing interest rates up to 25 percent, but limiting loan origination fees to four percent of the first $20,000 loaned, and two percent on amounts above $20,000. In addition, the regulations associated with the CLA prohibit prepayment penalties on loans made at interest rates authorized by the CLA.

In at least one case we are aware of, a licensee was using most of the practices listed above to deceive Washington citizens into accepting adjustable rate first mortgage loans with loan origination fees of 10 percent and higher. A systematic sales program was put into place, with extensive training for loan officers, to mislead borrowers into accepting predatory loans. Loan files were carefully constructed to demonstrate compliance with disclosure requirements. Yet interviews with consumers confirmed that the deceptive sales practices were employed and that consumers did not understand the terms of the loans that they entered into. Once a consumer understood the true terms of their loan, they also discovered that the loan frequently contained a large prepayment penalty that effectively prohibited refinancing out of the loan.

Despite the fact that this company was licensed under the CLA, and the CLA clearly had prohibitions on charging such a large loan origination fee or placing a prepayment penalty on a loan made under the CLA, DFI was unable to bring charges for violations of the CLA. Why? Federal law preempts state law restrictions on rates, fees, and charges on first mortgage loans, and OTS interpretation preempts state law restrictions on prepayment penalties on alternative mortgage loans. The only basis for action against the company was its use of deceptive sales practices. Fortunately, during DFI's investigation of these practices, we discovered other licensing and records violations that resulted in surrender of the licensee's license, and we continue to investigate the use of deceptive sales practices.

Legislative and Regulatory Responses in Other States:

The ANPR notes that several states have undertaken statutory or regulatory initiatives to protect their citizens from some of the abuses of predatory lending. For example, North Carolina has enacted legislation that will become effective in July of this year. The legislation places restrictions on prepayment penalties, the financing of credit insurance, and loan flipping, and defines high costs loans and places additional consumer protections on such loans, including a requirement for loan counseling. In addition, New York has proposed regulations that contain similar requirements.

First, DFI recognizes that there are prudent areas in financial institutions policy that require federal preemption. On occasion, DFI has advocated as much, recognizing that we now live in a global economy where common rules may be in the best interest of our citizens. Further, the aggressive nature of the preemption interpretations from federal regulatory agencies often give federally-chartered institutions a competitive advantage over state-chartered financial institutions, and in those cases, DFI has advocated parity for state-chartered institutions.

However, the public policy issue raised here is whether preemption issues shouldn't be exclusively decided by the elected representatives in Congress and where interpretive disputes arise between federal and state law, exclusively determined in the courts without reference to the interpretive statements of federal regulatory agencies. Given the current deference courts give to the interpretive statements of federal regulatory agencies, two appointed officials in the U.S. Treasury Department, as a practical matter, are disempowering the authority of 7,421 elected state legislators to make public policy in local legislatures. These elected officials must be free to take such steps as are necessary and prudent, within the scope of their authority and reasonable federal preemption, to address the problem of predatory lending.

DFI believes it is too early to judge the wisdom and effectiveness of the statutory and regulatory initiatives in North Carolina and New York. The proscriptive approach adopted by these two states is certainly attractive. It creates a clear set of prohibitions and a sense that something important is being done to address the problem. Enforcement cases brought under this approach should be simple document cases, easy to prove and win. DFI supports the right of each state to take its own course and we are eager to see how well these approaches work in addressing the problem. However, DFI has some doubts about the ability of such a proscriptive approach to actually solve the problem.

First, under the existing regime of federal preemption, it appears to us that many of the provisions of these laws will be ineffective. Specifically, federal law preempts any state law restriction of rates and fees on a first mortgage loan, of the use of an alternative mortgage feature such as a balloon payment, and of the use of a prepayment penalty on an alternative mortgage. This seems to us to preempt a broad range of prohibitions within the North Carolina statute and New York's proposed regulation. Much of what is left already exists in the Homeownership and Equity Protection Act of 1994 (HOEPA) amendments to Truth-in-Lending.

Second, our experience is that perpetrators of predatory lending are not concerned with compliance with the law in the first place. Predatory lenders typically don't have legal departments, compliance officers and audit teams researching and monitoring their compliance with state and federal law. Instead, the entities that are systematically engaged in predatory lending don't seem to care much about what the law says at all. They may invest substantial resources to make it appear that they are in compliance with the law, but they are rarely concerned with true compliance. It is unlikely that the passage of a state law is suddenly going to make the problem go away. Aggressive enforcement will be required.

While the idea of requiring borrowers in high cost loans to obtain counseling is intriguing, we will all have to wait to see how well it works. We are concerned that predatory lenders will steer borrowers to biased counselors (just as they are often steered to biased appraisers), that counseling will simply become another third party cost in the mortgage transaction, and that predatory lenders will simply create affiliates to provide counseling at inflated fees.

Third, to the extent that loan terms such as prepayment penalties, balloon payments and amortization features really are employed by legitimate lenders to expand access to credit for high risk borrowers, prohibitions on the use of these loan terms on high cost loans might significantly reduce access to credit for these borrowers.

Predatory Lending and Enforcement:

Where does that leave us? In our view, the only true solution to predatory lending is to enact statutory provisions prohibiting the use of unfair and deceptive sales practices in the origination of mortgage loans. For example, in Washington it is a violation of the Mortgage Broker Practices Act to:

- Directly or indirectly employ any scheme, device, or artifice to defraud or mislead any borrowers or lenders or to defraud any person;
- Engage in any unfair or deceptive act or practice against any person;
- Obtain property by fraud or misrepresentation;
- Solicit or enter into a contract with a borrower that provides in substance that the mortgage broker may earn a fee or commission through the mortgage broker's "best efforts" to obtain a loan even though no loan is actually obtained for the borrower;
- Solicit, advertise, or enter into a contract for specific interest rates, points, or other financing terms unless the terms are actually available at the time of soliciting, advertising, or contracting;
- Fail to make disclosures to loan applicants and non-institutional investors as required by the law and any other applicable state or federal law; and

- Make, in any manner, any false or deceptive statement or representation with regard to the rates, points, or other financing terms or conditions for a residential mortgage loan or engage in bait and switch advertising.

Surely many other prohibitions against deceptive sales practices could be drafted.

In addition, the law should include stiff penalties for such practices, including criminal penalties for theft by deception. And finally, regulatory agencies must aggressively enforce these statutory provisions. Our experience suggests that this is not easy. Deceptive sales practice cases are not easy to make. Examiners cannot document such cases simply by examining loan files, since the loan files will often contain all of the required disclosures and other required paperwork. These cases can only be made by sifting through consumer complaints, by interviewing consumers and establishing a pattern of practices from their stories, by comparing documents obtained from consumers with those in the loan files, and by obtaining sales training documents from the company and interviewing employees. Bringing such cases to hearing requires preparing and presenting a large body of testimony and evidence, evidence sufficient to establish the systematic use of a pattern of deceptive practices with the intent to mislead and defraud borrowers. It is a long, expensive and confrontational process, but we believe that it is the best way to truly solve the problem of predatory lending.

Conclusion:

We urge the OTS to narrow the scope of its preemptive interpretations under AMTPA, particularly in the area of prepayment penalties, and to more carefully consider and better understand the impact of any new preemptive interpretations. It is our view that the elected officials in state legislatures across the country should be left to determine what response to predatory lending best fits the needs of their particular state. In addition, we encourage OTS to provide states with meaningful opportunities to participate in future OTS preemption determinations, as directed by Executive Order 13132.

Thank you for the opportunity to comment.

Sincerely,

John L. Bley
Director of Financial Institutions

cc: Sen. Margarita Prentice, Chair, Washington State Senate Commerce, Trade, Housing and Financial Institutions Committee
Rep. Brian Hatfield, Co-Chair, Washington State House Financial Institutions and Insurance Committee
Rep. Brad Benson, Co-Chair, Washington State House Financial Institutions and Insurance Committee
Mr. Neal Milner, President and CEO, Conference of State Bank Supervisors

Attachment